COST SHARING AGREEMENTS AT ARMS-LENGTH: *ALTERA* SHOULD BE REVERSED BY THE NINTH CIRCUIT

BRAD HEMMER*

I. INTRODUCTION

On July 24th, 2018, the Internal Revenues Services (IRS) scored a huge victory against American companies, specifically tech companies, using cost sharing agreements with foreign subsidiaries to reduce their tax liability in the United States. The three-judge Ninth Circuit panel ruled in favor of the IRS 2-1 in *Altera Corp. & Subsidiaries v. Commissioner*, reversing the tax court.[1] The victory was short-lived, however, as one of the two judges making the majority, Judge Stephen Reinhardt, passed away on March 29th, 2018.[2] The case was heard on October 11, 2017, which means Judge Reinhardt heard the case, passed away, then the opinion was published.[3] Judge Reinhardt was a deciding vote from the grave. The 9th Circuit has withdrawn the opinion in the wake of Judge Reinhardt's passing and decided to re-hear the case. Judge Susan Graber has been designated to preside over the re-hearing of the case.[4]

The outcome of the case has major tax implications for American companies and their foreign subsidiaries.[5] The importance of this case is noticed simply by looking at the number of amicus briefs filed by large corporations who stand to gain considerable amounts in tax

* *Juris Doctor Candidate*, 2020, The Ohio State University Michael E. Moritz College of Law.

[1] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989, at *18 (9th Cir. July 24, 2018).

[2] *Ninth Circuit Court of Appeals Mourns Passing of Justice Stephen Reinhardt,* U.S. Courts for the Ninth Circuit Public Information Office (Mar. 30, 2018).

[3] *Altera*, 2018 WL 3542989.

[4] Altera Corp. v. Comm'r., 898 F.3d 1266 (9th Cir. 2018).

[5] Luke Stangel, *IRS Wins Court Case Over Intel, in Decision That Could Impact Silicon Valley's Biggest Giants,* SILICON VALLEY BUS. J. (July 25th, 2018), https://www.bizjournals.com/sanjose/news/2018/07/25/irs-intel-overseas-tax-case-intc-silicon-valley.html. Although the case is relatively small only involving $80 million in income from Altera, there is a lot of other money at stake. Google would gain $3.5 billion if Altera was to win this case and many other tech companies stand to gain substantial tax relief. *Id.*

relief.[6] The case greatly impacts technology companies who are using cost sharing agreements and stock-based compensation with their foreign subsidiaries, often located in tax havens, to take large tax deductions in the U.S. At the heart of the case are I.R.C. § 482 and Treasury Regulation § 1.482.[7] The case is also concerned with the amount of deference given to the Treasury regulations. Another issue the Ninth Circuit is particularly interested in hearing during the next oral argument is "whether the six-year statute of limitations [is] applicable to procedural challenges under the Administrative Procedure Act."[8]

This article will first detail the tax avoidance strategy Altera and similar corporations have been using. Then, this article will explain the administrative procedure issues involved in the case. Finally, this article will discuss why Altera should win the case.

II. WHAT IS A COST SHARING AGREEMENT AND WHAT ARE THE TAX CONSEQUENCES?

A cost sharing agreement is made between a parent company, such as Altera Corporation (Altera), incorporated in the U.S., and one of its subsidiaries often in a foreign country with little to no income tax, such as Altera International, incorporated in the Cayman Islands.[9] The agreement between the two parties is to share the costs and risks of

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[6] *See* Brief of Amicus Curiae Amazon.com, Inc. in Support of Petitioner Appellee and Affirmance, Altera Corp. v. Comm'r., 2018 WL 3542989 (9th Cir. July 24, 2018) (Nos. 16-70496, 16-70497), 2016 WL 5808867; Brief of the Chamber of Commerce of the United States of America as Amicus Curiae in Support of Petitioner-Appellee and Affirmance, *Altera*, 2018 WL 3542989 (Nos. 16-70496, 16-70497), 2016 WL 5415936; Amicus Curiae Brief Supporting Appellee and Affirmance on Behalf of Cisco Sys., Inc., *Altera*, 2018 WL 3542989 (Nos. 16-70496, 16-70497), 2016 WL 5369278; Amici Curiae Brief Supporting Appellee and Affirmance on Behalf of Software and Info. Industry Assoc. et al., *Altera*, 2018 WL 3542989 (Nos. 16-70496, 16-70497), 2016 WL 5369276; Brief of Amicus Curiae TechNet in Support of Appellees and Affirmance, *Altera*, 2018 WL 3542989 (Nos. 16-70496, 16-70497), 2016 WL 5369097.

[7] I.R.C. § 482 (2012); Treas. Reg. § 1.482 (as amended in 2015).

[8] Altera Corp. v. Comm'r, No. 16-70496, 2018 WL 4924367, at *1 (9th Cir. Sept. 28, 2018).

[9] *Amended and Restated Certificate of Incorporation of Altera Corporation*, FINDLAW, https://corporate.findlaw.com/contracts/formation/certificate-of-incorporation-amended-and-restated-altera.html (last visited Apr. 18, 2019); *Subsidiaries and Branch Offices*, INTEL, https://www.intel.cn/content/www/cn/zh/programmable/common/legal/branches.html (last visited Apr. 18, 2019).

researching and developing intangible property. The reason these agreements are so common for tech companies is because of the research and development aspect needed to make the intangible property. The income from the property that is produced must be shared between the parent company and subsidiary.[10] The income must be shared "commensurate with the income the intangible produces."[11] The commensurate with income standard was added in the 2003 amendment to I.R.C. § 482, which governs transfer pricing.[12]

Cost sharing agreements allow the U.S. company to transfer the intangible property to the foreign subsidiary without royalty fees because the foreign subsidiary contributed in making the property with research and development costs.[13] Rather than Altera do all of the research and development on the property, then sell it to Altera International, which would be a taxable transaction, they share the cost of the research and development and both get to use the property. The companies often reimburse each other for costs of the research and development, which is taxable as income. When the parent company pays the employees, they are reimbursed by the subsidiary, which is taxed. Corporations in higher tax jurisdictions, such as the U.S., do not want royalties because the cost of developing the intangible property will cost less then the income tax on the royalties that would be received from the subsidiary.[14] Companies in higher tax jurisdictions also do not want reimbursement on compensation costs, especially stock-based compensation because it is deductible; more on that later. The parent company is not concerned about losing royalty income, they only care about their global profit which is higher using cost-

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[10] I.R.C. § 482 (2012) ("In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income . . .").

[11] *Id.*

[12] Treas. Reg. § 1.482-4 (as amended in 2011).

[13] *Cost Sharing Agreement*, BUS. DICTIONARY, http://www.businessdictionary.com/definition/cost-sharing-agreement.html (last visited April 18, 2019).

[14] Richard Weiss, *How Could the Altera Ruling on Cost Sharing Arrangements Impact Tax Payers?*, MBAF (June 8, 2016), https://mbafcpa.com/advisories/special-report-altera-ruling-cost-sharing-arrangements-impact-tax-payers.

sharing agreements because of the reduced tax liability.[15] The IRS explains the criteria that must be met for a cost sharing transaction and examples of agreements that do not qualify as cost sharing agreements in Treasury Regulation 1.482.[16]

The issue directly at hand in *Altera* is the use of stock-based compensation to pay employees for the research and development covered by the cost sharing agreement.[17] Stock-based compensation is often used because it gives employees an incentive to increase the value of the company, and thus increase the value of their shares. Another advantage of stock-based compensation is that it gives corporations a means to compensate employees without using cash.[18] Corporations also value this form of compensation because it can be deducted from their tax bill.[19] Stock-based compensation is usually only used to pay employees of your own corporation because the value fluctuates so frequently and because the value of the compensation is then tied to the corporation.

However, the deduction is only valuable to the parent corporation in the United States because of the high corporate tax rate.[20] In so-called "tax havens," such as the Cayman Islands, the deduction for stock-based compensation is useless because corporations there have no tax liability to deduct from.[21] This deduction also has the effect of lowering the tax rate of the U.S. corporation. Technology companies that generate income from intangible property use stock-based

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[15] Mark Martin, *International Transfer Pricing*, HOUSTON LAWYER (July/Aug. 2006).
[16] Treas. Reg. § 1.482–7 (as amended in 2013).
[17] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989, at *1 (9th Cir. July 24, 2018).
[18] *What Are the Advantages of Employee Stock Options?*, ALLBUSINESS, https://www.allbusiness.com/what-are-the-advantages-of-employee-stock-options-2460-1.html (last visited April 18, 2019) ("Employees can reap some of the financial benefits of a successful business. This can result in employees making far more money above and beyond their annual salaries.").
[19] Joel Rothenburg, *Tax Implications of Equity Based Compensation*, DGC (May 16, 2017), https://www.dgccpa.com/perspectives/tax-implications-of-equity-based-compensation-424.
[20] *See* Dan Caplinger, *How Do the New US Corporate Tax Rates Compare Globally? A Foolish Take*, USA TODAY (July 10, 2018), https://www.usatoday.com/story/money/taxes/2018/07/10/how-new-us-corporate-tax-rates-compare-globally/36561275.
[21] *Cayman Tax System*, WORLD.TAX, https://www.world.tax/countries/cayman-islands/cayman-islands-tax-system.php (last visited April 18, 2019).

compensation to deduct from their tax liability by a large number.[22] For an example of just how drastic these companies' tax liability would change without being able to deduct stock-based compensation in the United States, Facebook paid a tax rate of just 10% in 2017, 11% lower then the corporate tax rate of 21%.[23]

III. THE IRS VIEW ON COST SHARING AGREEMENTS AND STOCK-BASED COMPENSATION

Stock-based compensation was being used in conjunction with a cost sharing agreement between Altera and Altera International. In addition to the benefit of cost sharing agreements avoiding an exchange of royalties, they also allow the U.S. parent companies to deduct stock-based compensation from the employee compensation in the cost sharing agreement. There is one statute and one Treasury Regulation that govern cost sharing agreements and stock-based compensation as it pertains to Altera.

The general purpose of I.R.C. § 482 is to place the controlled taxpayer on a tax parity with an uncontrolled taxpayer.[24] I.R.C. § 482 was codified as part of the Internal Revenue Code of 1954, although its authority to reallocate income has been used since 1928.[25] The statute originally had the purpose of stopping a company in a high tax bracket from selling its products to a subsidiary in a low tax bracket at a price below fair market value to shift the income.[26] The 1928 act remained largely unchanged until the Tax Reform Act of 1986 amended it. The Tax Reform Act of 1986 amended the statute to

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[22] See, e.g., Amazon.com, Inc., Annual Report (Form 10-K) (Feb. 1, 2018) (Amazon paid $4,215,000,000 in stock based compensation in 2017 alone. Amazon filed an amicus curiae brief in favor of *Altera.*); Facebook, Inc., Annual Report (Form 10-K) (Feb. 1, 2018) (Facebook paid $3,720,000,000 in what the call "share-based compensation," which is the same as stock based compensation.); Cisco Systems, Inc., Annual Report (Form 10-K) (Sept. 6, 2018) (Cisco, who filed an amicus curiae brief in favor of *Altera* paid $1,599,000,000 in share-based compensation in 2018.).

[23] Laura Davison, *Tax Breaks for Stock Pay Curbed, Handing Tech 'Huge' Liabilities,* BOSTON GLOBE (August 2, 2018), https://www.bostonglobe.com/business/2018/08/02/tax-breaks-for-stock-pay-curbed-handing-tech-huge-liabilities/lqNdq6OZSQVCfwOB4pk9gK/story.html.

[24] Treas. Reg. § 1.482-1 (as amended in 2015); *id.* § 1.482-1(i)(5) (A controlled group of taxpayers is a group of taxpayers that are "owned or controlled directly or indirectly by the same interests.").

[25] Glen Madere, *A Planning Guide to Section 482*, 6 DEL. J. CORP. L. 237 (1981).

[26] *Id.* (citing E. I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979)).

include "[i]n the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[27] I.R.C. § 482 now empowers the Secretary of the Treasury to:

> "[D]istribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[28]

The standard to determine the income, deductions, credits, or allowances is an arm's length transaction between uncontrolled taxpayers.[29] Many view § 482 as giving the Secretary too much power and having the potential to be abused. This is because the IRS' reallocation of income is presumed to be right and the burden to overcome that presumption is high.[30]

The regulation involved in *Altera* is Treasury Regulation 1.482-7, which was put into effect on January 9, 2009.[31] More specifically, 1.482-7(d) deals with the costs of intangible development,[32] which was the subject of Altera's cost sharing agreement with Altera International. The regulations states:

> IDCs mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation

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[27] I.R.C. § 482 (2012)
[28] *Id.*
[29] Treas. Reg. § 1.482-1(b) (as amended in 2015).
[30] E.C. Lashrooke, Jr., *I.R.C. § 482 Commensurate with Income Standard for Transfers of Intangibles*, 1 DEPAUL BUS. L.J. 173, 175 (1989).
[31] Paul Flignor, *US Department of Treasury Issues Final Cost Sharing Regulations*, DLA PIPER (Jan. 25, 2012), https://www.dlapiper.com/en/us/insights/publications/2012/01/us-department-of-treasury-issues-final-cost-shar__.
[32] Treas. Reg. § 1482-7(d) (as amended in 2013).

> of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA.[33]

The regulation then defines what stock-based compensation covers and how the IRS will identify stock-based compensation attributable to the cost sharing agreement.[34]

IV. Background of Altera

Altera and Altera International entered into a technology research and development cost sharing agreement on May 23, 1997.[35] The parent and subsidiary agreed to share the risks and costs of research and development from 1997-2007.[36] Altera compensated certain employees in stock and cash, but only included the cash in the cost pool of the cost sharing agreement with Altera International.[37] The stock-based compensation paid out to employees was not included in the cost pool and thus was not shared.[38] This allowed Altera to take a large deduction in the United States, where the tax rate is high, as compared to the 0% tax rate enjoyed by Altera International in the Cayman Islands.[39] Altera, and most major U.S. tech companies involved in cost sharing agreements do not include the stock-based compensation because they are required to deal with their subsidiaries at an arm's length standard, which means in the same manner as

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[33] *Id.* § 1.482-7(d)(iii). For purposes of this regulation, an "IDC" is an intangible development cost. *Id.* § 1.482-7(a)(1). For purposes of this regulation, an "IDA" is the intangible development activity. *Id.* § 1.482-7(d).

[34] *Id.* § 1.482-7(d)(iv)(3)(i-ii). Forms of stock based compensation include stock options, equity and instruments, or rights to stock. *Id.* § 1.482-7(d)(iv)(3)(i). Stock based compensation given during the term of the cost sharing agreement and reasonably allocable to the intangible development will be considered a development cost. *Id.* § 1.428-7(d)(iv)(3)(ii).

[35] Altera Corp. v. Comm'r., 145 T.C. 91, 93 (2015), *rev'd sub nom.*, No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018). The research and development agreement was to make a programmable logic device and the related programming for the device. They also entered a technology license agreement on the same day. *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] Claire Boyte-White, *Why Are The Cayman Islands Considered a Tax Haven?*, INVESTOPEDIA (Nov. 9, 2017), https://www.investopedia.com/ask/answers/100215/why-cayman-islands-considered-tax-haven.asp.

unrelated taxpayers.[40] Altera did not believe unrelated taxpayers would include stock-based compensation in the cost pool, therefore they would not be required to do so.[41] The Secretary of the Treasury, pursuant to § 482, allocated an additional $80,393,721 of payments for the cost sharing agreement from Altera International to Altera, which is taxable income.[42] Those compensation payments were deductible as stock-based compensation, but were not deductible as a payment from Altera International.[43]

V. ARGUMENTS MADE BY ALTERA AND THE IRS

The arguments made by Altera revolve around statutory interpretation and deference. One argument is the "commensurate with income" addition made by the 1986 tax reform did not replace the arm's length standard.[44] Evidence of this is offered in Treasury's 1988 White Paper, where it endorsed the arm's length standard: "intangible income must be allocated on the basis of comparable transactions if comparables exist."[45] The White Paper is a study of I.R.C. § 482 done by the IRS and the Treasury.[46] The argument is that the commensurate with income standard is supposed to be applied with the arm's length standard, not replace it.[47]

The next argument is that the IRS Commissioner's interpretation of § 482 is unreasonable and therefore should not receive deference. Altera argues the interpretation is unreasonable because it goes against the stated purpose of the statute, which is to bring controlled taxpayers to parity with uncontrolled taxpayers.[48] It is also unreasonable because the legislative history of the 1986 tax reform does not support a new interpretation of commensurate with income replacing arm's length

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[40] Brief for the Appellee at *28, Altera Corp. v. Comm'r., 2018 WL 3542989 (9th Cir. July 24, 2018) (Nos. 16-70496, 16-70497), 2016 WL 4751419.
[41] *Id.* at *18, *28–*29.
[42] Brief for the Appellant at *26, Altera Corp. v. Comm'r., 2018 WL 3542989 (9th Cir. July 24, 2018) (Nos. 16-70496, 16-70497), 2016 WL 3537355.
[43] *Id.*
[44] Brief for the Appellee, *supra* note 40 at *10–*14.
[45] I.R.S. Notice 88-123, 1988-2 C.B. 458, 474 ("White Paper"). (The White paper is a study published by the Treasury in 1988 that endorsed the arm's length standard to examine transactions between controlled taxpayers.)
[46] *Id*. at 458.
[47] *Id.*
[48] Brief for the Appellee, *supra* note 40 at *56.

transactions.[49] It is also unreasonable because the rule was made without any connection to evidence or facts.[50]

The final argument made by Altera involves the APA's decision-making procedures. Altera argues the Commissioner did not respond to any comments during the notice and comment process and the rule lacks any factual basis.[51]

The Commissioner argues that the IRS should be afforded *Chevron* deference because the agency, in this case the IRS, reached its rule in a logical and rational manner, and its interpretation of § 482 is permissible.[52] The Tax Court had previously given the IRS regulation *State Farm* deference.

The Commissioner also argues the commensurate with income standard does not replace the arm's length transaction standard because they do not conflict with each other.[53] The commensurate with income standard must be used because there is no comparable transaction for the purpose of the arm's length standard since unrelated taxpayers would never include stock-based compensation in a cost sharing agreement.[54]

Another argument involves a previous cost sharing agreement case, *Xilinx*. In that case, the Ninth Circuit determined that "whether a transaction produces an arm's length result generally will be determined by reference to comparable uncontrolled transactions."[55] However, the court did not consider the 2003 amendments, which the IRS claims are valid, to Treasury Regulation 1.482-7, which required all costs to be shared in cost sharing agreements.[56] The 2003 amendments clarified stock-based compensation is within the definition of "costs" that must be shared in cost sharing agreements.[57] The Commissioner's brief also raises the legislative history of the 1986 tax reform which added the commensurate with income standard

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[49] *Id*. at *65–*68.
[50] *Id*. at *71–*72.
[51] *Id.* at *36–*38.
[52] Brief for the Appellant, *supra* note 42 at *43–*44.
[53] *Id.* at *48–*61.
[54] *Id.*
[55] Xilinx, Inc. v. Comm'r, 598 F.3d 1191, 1195 (9th Cir. 2010) (The Ninth Circuit found stock based compensation should not be included in research and development costs of cost sharing agreements).
[56] Brief for the Appellant, *supra* note 42 at *47.
[57] *Id.* at *21 (citing Options Under Section 482, 67 Fed. Reg. 48, 997 (July 29, 2002)).

because it is difficult to find unrelated party transactions to compare cost sharing agreements to.[58]

VI. PROCEDURAL HISTORY OF ALTERA

The litigation in this case began with Altera bringing an action by petitioning the notice of deficiency received from the IRS.[59] The United States Tax Court ruled in favor of Altera by a unanimous 15-0 decision.[60] The Commissioner appealed to the Ninth Circuit, where the case was argued on October 11, 2017.[61] The Ninth Circuit reversed and gave the Commissioner *Chevron* deference for Treasury Regulation 1.482-7 by a 2-1 decision.[62] Judge Thomas, who was joined by Judge Stephen Reinhardt, wrote the majority opinion, which was filed on July 24, 2018.[63] Judge O'Malley wrote the dissent.[64] However, Judge Reinhardt, who was one of the deciding majority votes, died on March 29th, 2018.[65] Although Judge Reinhardt heard the case in 2017 and participated in the decision between October 2017 and the date of his passing, he was not alive at the time the decision was filed.

His colleagues viewed Judge Reinhardt as a "liberal lion" and he was widely regarded as a legal giant.[66] Judge Reinhardt previously wrote the dissent for *Xilinx,* an opinion that is very similar to *Altera,* so it is no surprise he ruled in favor of the IRS in *Altera*. In *Xilinx,* Judge Reinhardt dissented because he had doubts as to whether the parent company and the foreign subsidiary allocated the cost of stock-based compensation in a manner consistent with the arm's length standard.[67]

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[58] *Id.* at *52–*57.

[59] Petition, Altera Corp. v. Comm'r., 145 T.C. 91, 93 (2015) (No. 9963-12), 2012 WL 9490963.

[60] *Altera*, 145 T.C. at 93.

[61] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018).

[62] *Id.* at *18.

[63] *Id.*

[64] *Id*. at *18.

[65] *Ninth Circuit Court of Appeals Mourns Passing of Justice Stephen Reinhardt,* UNITED STATES COURT FOR THE NINTH CIRCUIT (March 30, 2018), http://cdn.ca9.uscourts.gov/datastore/ce9/2018/03/30/Obit_Reinhardt.pdf.

[66] Sam Roberts, *Stephen Reinhardt, Liberal Lion of Federal Court Dies at 87*, N.Y. TIMES (April 2, 2018), https://www.nytimes.com/2018/04/02/obituaries/stephen-reinhardt-liberal-lion-of-federal-court-dies-at-87.html.

[67] Xilinx, Inc. v. Comm'r, 598 F.3d 1191, 1199 (9th Cir. 2010).

Although the Ninth Circuit published the opinion for *Altera,* they have since then withdrawn that opinion.[68] The decision to rehear the case is certainly a strange one since Judge Reinhardt had passed away many months before the opinion was published. In a footnote of the withdrawn opinion the Court acknowledged that Judge Reinhardt "fully participated in this case and formally concurred with the majority opinion prior to his death."[69] Just Fourteen days after publishing the opinion that acknowledged Judge Reinhardt's participation in the case, the Court withdrew the opinion "to allow for time for the reconstituted panel to confer."[70] Presumably, the Ninth Circuit did not want the deciding vote in a case with large consequences coming from the grave. The sudden change of heart just two weeks after publishing the opinion is certainly interesting.

Each court has different procedural rules in cases of a Judge passing away after hearing cases but before the opinions are published. In the Supreme Court, Justices must be active members of the court when the argument is heard and when the decision is published in order for their vote to count.[71] The Ninth Circuit rule is "[i]f a member of a three judge panel becomes unavailable by reason of death, disability, recusal or departure from the Court and the case is under submission, the Clerk shall draw a replacement as needed, utilizing a list of active judges randomly drawn by lot."[72]

The Ninth Circuit has previously heard cases *en banc* with a new judge in cases where an original member of the panel left the Court between the time the case was originally heard and the opinion was published.[73] There are at least five other cases that Judge Reinhardt was presiding where he has since been replaced by an active judge through random drawing.[74] In most of those cases, the replacing judge

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[68] Altera Corp. v. Comm'r, 898 F.3d 1266 (9th Cir. 2018).
[69] Altera Corp. v. Comm'r, No. 16-70496, 2018 WL 3542989 n.** (9th Cir. July 24, 2018).
[70] *Altera*, 898 F.3d at 1266.
[71] Irin Carmon, *What Happens to the Big Supreme Court Cases After Scalia's Death,* MSNBC (Feb. 13, 2016, 8:24 PM), http://www.msnbc.com/msnbc/what-happens-the-big-supreme-court-cases-after-scalias-death.
[72] 9th Cir. Gen. Order 3.2(h).
[73] Alaska Airlines Inc. v. Schurke, 898 F.3d 904 n.* (9th Cir. 2018) ("This case was submitted to a panel that included Judge Kozinski. Following Judge Kozinski's retirement, Judge Paez was drawn by lot to replace him.").
[74] Packsys, S.A. de C.V. v. Exportadora de Sal, S.A. de C.V., 899 F.3d 1081 (9th Cir. 2018); Gallinger v. Becerra, 898 F.3d 1012 (9th Cir. 2018); Smith v. Pennywell, 742 F. App'x 230 (9th Cir. 2018); Torres v. Goddard, 739 F. App'x 392 (9th Cir. 2018); United States v. Millan, 730 F. Appx. 438 (9th Cir. 2018).

has "read the briefs, reviewed the record, and listened to oral argument."[75] However those cases do not publish an opinion; instead they withdraw the opinion and hear an entirely new oral argument with the replacing judge participating, as will be done in *Altera*. *Altera* had another oral argument to the panel that now includes Judge Susan Graber, who was randomly chosen.[76] Judge Graber will be allowed to independently review the case and make a decision that will be the deciding vote.

The Ninth Circuit made the right decision to withdraw the opinion and review the case with Judge Graber. A judge should have to be an active judge for the entirety of the process up to the day the decision is published in order to decide the case. A crucial part of the decisionmaking process for judges is reading the opposing opinion.[77] Although rare, it is not unheard of for judges to switch their decision after reading the opposing opinion and debating with other judges.[78] Admittedly, it was unlikely that Judge Reinhardt would have switched his vote to rule in favor of Altera in this case after reading the dissent from Judge O'Malley because he decided in favor of the IRS in *Xilinx* and he is well-known for his liberal ideology. However, we cannot assume Judge Reinhardt would not have changed his mind in a case with such huge consequences. Judges must have the opportunity to hear the arguments of the other side in order to make a reasoned decision.

VII. PREVIOUS OPINIONS WRITTEN IN *ALTERA*

The Tax Court originally found in favor of Altera by a unanimous 15-0 decision.[79] The Tax Court's majority opinion found the

[75] *Gallinger*, 899 F.3d at 1022.
[76] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018).
[77] Jonathan H. Adler, *The Dead Can Vote (At Least on the Ninth Circuit)*, REASON (July 25, 2018, 3:49 PM), https://reason.com/volokh/2018/07/25/the-dead-can-vote-at-least-on-the-ninth.
[78] *See* Rowl, Evans & Robert Novak, *Justice Kennedy's Flip,* WASH. POST (Sept. 4, 1992), https://www.washingtonpost.com/archive/opinions/1992/09/04/justice-kennedys-flip/17eb4e0b-72f6-4678-b5bb-7a3e8f79b395/?utm_term=.9d0196a1c97e (depicting one of the most famous cases involving a judge switching, *Planned Parenthood v. Casey,* which affirmed *Roe v. Wade*). Justice Kennedy was thought to originally be part of a 5-4 majority to reverse *Roe* after hearing the case, then during judicial conferences flipped to make a 5-4 majority affirming *Roe*.
[79] Altera Corp. v. Comm'r., 145 T.C. 91 (2015).

commensurate with income standard was intended to work with the arm's length standard and not replace it because of the 1988 White Paper which states, "The general goal of the commensurate with income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."[80] The Tax Court leaned heavily on the precedent in *Xilinx* which found that unrelated parties would not share the value of stock-based compensation in a cost sharing agreement. *Xilinx,* along with the White Paper, was used by the court to show the arm's length standard should not be supplanted by the commensurate with income standard:

> In Xilinx Inc. v. Commissioner, 125 T.C. at 56–58, we concluded that Congress never intended for the commensurate-with-income standard to supplant the arm's-length standard. In the 1988 White Paper Treasury and the IRS similarly concluded that Congress intended for the commensurate-with-income standard to work consistently with the arm's-length standard.[81]

In other words, because unrelated parties would not share these costs, then related parties in an arm's length agreement do not have to either.[82] The Tax Court recognized the 2003 amendment to Treasury Regulation 1.482-7 sought to include stock-based compensation in costs, but that is not consistent with the arm's length standard.

Ultimately, when deciding how much deference to give the IRS interpretation of the regulation, the Tax Court concluded that it did not matter whether it applied *State Farm* or *Chevron.*[83] This is because the Treasury failed to use reasoned decisionmaking and could not justify its position to use a commensurate with income standard rather than an arm's length standard.[84]

The Ninth Circuit, which at the time included Judge Reinhardt, reversed the Tax Court's decision. The court found the Treasury did comply with the APA procedures for rulemaking and therefore the 2003 amendment to include stock-based compensation in cost sharing

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[80] *Id.* at 121 (citing I.R.S. Notice 88-123, 1988-2 C.B. 458, 472 ("White Paper)).
[81] *Id.*
[82] *Id.*
[83] *Id.* at 125.
[84] *Id.*

agreements was valid.[85] The court found the Treasury adequately replied to comments during the notice and comment period required by the APA.[86] When applying *State Farm* as the Tax Court did, the Ninth Circuit determined the Treasury did comply with the requirement of reasoned decisionmaking.[87] The Commissioner's interpretation of the regulation also survives the *Chevron* test and is therefore given a high level of deference because the interpretation was not arbitrary and capricious.[88] The Ninth Circuit did not find *Xilinx* controlling because the 2003 amendment did not apply to the tax years in question and the parties did not debate the administrative authority.[89]

VIII. What Issue Is the New Three Judge Panel Interested In

The second oral argument heard by the Ninth Circuit, this time including Judge Graber, took place on October 11, 2018.[90] Before the next oral argument was heard, the Court issued an order to the parties informing them to be prepared to discuss whether there is a statute of limitations that applies in this case.[91] The Court cited *Perez-Guzman v. Lynch* in the order, which discusses a six year statute of limitation for procedural challenges to the APA.[92]

During the oral re-argument, the Commissioner was challenged by Judge O'Malley, that I.R.C. § 482 is ambiguous because there is nothing in the statute that explicitly states the commensurate with income standard is applicable to this case.[93] Judge Thomas seemed to be leaning toward finding for Altera, as she did in the original opinion with her dissent.

Judge Graber, presumably the deciding vote, seemed more concerned with the statutory interpretation than with the administrative law issues at play. Counsel for Commissioner explained his view that Congress made the amendments to § 482 because they did not think

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[85] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989 (9th Cir. July 24, 2018).
[86] *Id.* at *13.
[87] *Id.* at *10.
[88] *Id*. at *17.
[89] *Id.* at *18.
[90] *See* Altera Corp. v. Comm'r., 898 F.3d 1266 (9th Cir. 2018).
[91] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 3542989, at *1 (9th Cir. July 24, 2018).
[92] Perez-Guzman v. Lynch, 835 F.3d 1066, 1077–79 (9th Cir. 2016).
[93] Oral Argument at 3:17, Altera Corp. v. Comm'r., No. 16-70496 (Oct. 16, 2018), https://www.ca9.uscourts.gov/media/view_video.php?pk_vid=0000014449.

there was a perfect comparable to establish an arm's length standard, and thus needed commensurate with income.[94] The Commissioner makes the point that the Treasury originally believed the arm's length standard was commensurate with incomeand, therefore, the amendments are just making this explicit to get rid of any ambiguity in the regulation. Their position is that unless the uncontrolled transaction satisfies the commensurate with income standard, it is not a comparable transaction to a related party transaction.[95] However, if that were true, then the IRS could always claim there is no perfect comparable and use the commensurate with income standard for everything to get the most favorable tax rulings.

The Commissioner seemed to have no answer for Altera's argument that the IRS could then do away with comparability altogether and just use commensurate with income for every transaction. Judge O'Malley asked for evidence or economic theory supporting the commensurate with income requirement, perhaps trying to show Judge Graber there is no evidence.[96] The evidence mentioned by counsel was that the IRS is allowed to make periodic adjustments to income under the commensurate with income standard. He points out that no one is arguing the IRS cannot do that without third-party evidence.[97] However, no one is arguing that point because there is evidence from unrelated party transactions using a commensurate with income standard, which makes it consistent with the arm's length standard. In this case, there is no third-party evidence of what unrelated parties do, so the commensurate with income standard is inconsistent with the arm's length standard.

Counsel for Commissioner also argues that their interpretation of the regulation is not just a permissible reading, but rather the best reading of the regulation.[98] This was during an interesting conversation with Judge Thomas regarding the level of deference that should be given to Treasury's reading of § 482, which they both agreed should be *Auer* deference. Counsel again states Treasury's position that explicitly stating the commensurate with income standard in the statute was just a way to codify the ambiguity of the arm's length standard.[99]

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[94] *Id.* at 6:26.
[95] *Id* at 7:52.
[96] *Id.* at 8:38.
[97] *Id.* at 11:46.
[98] *Id.* at 12:30.
[99] *Id.* at 15:00.

During the counsel for Altera's time in front of the panel, Judge Graber seemed to be fixated on the words "transfer or license" in the statute, pointing out that the statute requires a transfer or license of intangible property the income must be commensurate with income attributable to the intangible property. Judge Graber almost immediately interrupted counsel after he spoke just one sentence.[100] The Judge immediately asked counsel for Altera why this cost sharing agreement was not a transfer because in her mind the statute requires that if this was a transfer, the standard is commensurate with income. Counsel for Altera pointed out that the statute only covers royalty payments and this cost sharing agreement was for future income.[101] A key point that counsel for Altera may have missed was that stock-based compensation is NOT an actual economic cost, the company is not paying any actual money to the employees.

Judge Graber seemed to believe the commensurate with income standard should be used in a transfer, but as counsel for Altera explains, the regulations always begin with an arm's length standard.[102] That is how Treasury has always operated and they should not be allowed to abandon that now. He also made sure to remind the Judges that the whole purpose of § 482 is to create tax parity, which is why the arm's length standard applies. In the absence of any comparable transaction between unrelated parties, Counsel suggested an economic analysis must be used, which Treasury did not do in this case. Judge Graber believes Congress told the Treasury department what to do in that situation, which is bad news for Altera.[103] What Judge Graber seemingly fails to see is the commensurate with income standard must be consistent with the arm's length standard, Treasury has even said so themselves. In this case, Treasury had comparable transactions but discredited them to make up their hypothetical transaction in order to get more tax money.

Counsel for Altera also frequently mentioned that the Tax Court did not believe Treasury had any evidence to change the arm's length standard, and they do not have the authority to get rid of the parity purpose. The Tax Court also concluded there was in fact comparable transactions that Treasury threw away.[104] Again referencing the Tax Court's expertise, counsel mentions how rare it is for that court to

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[100] *Id.* at 16:47.
[101] *Id.* at 18:12.
[102] *Id.* at 20:08.
[103] *Id.* at 22:50 (hinting that Congress gives Treasury the power to allocate income and costs using the commensurate with income standard).
[104] *Id.* at 24:00.

make a unanimous decision.[105] Certainly, the panel of judges must think twice before overruling Fifteen experts. Counsel also claimed that Commissioner's reading of the statute is unreasonable because they throw out the entire arm's length standard, and thus go against the purpose of § 482 which is parity. Along with Treasury's impermissible reading, Counsel also states the Treasury does not get *Auer* deference because they need to ask for that deference, which they failed to do.[106]

Counsel continued his assault on the commensurate with income standard throughout the argument effectively mentioning it cannot be used to place extra burdens on related parties. It was clear the theme of counsel for Altera's argument was the Treasury and Commissioner are simply throwing away the arm's length standard without telling anyone until this very case. Altera views this action by Treasury as an abuse of power and an extreme position.

On rebuttal, counsel for the Commissioner points out that the commensurate with income standard is purely internal and does not require companies to look at unrelated party transactions.[107] Counsel agrees with Judge Graber that the commensurate with income standard is a requirement, but does not respond to the argument that Treasury is throwing away the arm's length standard without telling anyone in the notice and comment period. In fact, counsel believes they do not have to use third party transactions as evidence at all, indicating the arm's length standard is no longer the default standard.

Judge O'Malley makes an interesting point, asking how Congress could have thought of this problem in 1986 when they thought about commensurate with income, as Commissioner claims when using legislative history, if Commissioner and Amici claim stock-based compensation is a new issue that is allowing for tax avoidance.[108] The question seems to show the legislative history is not an indication Congress wanted to use the commensurate with income standard to stop situations like this one.

Overall the most surprising part of the oral argument was the lack of discussion regarding the APA and reasoned decisionmaking. The argument almost exclusively centered on the actual text of § 482, as well as what the commensurate with income standard means for the arm's length standard. The argument is best summarized by Mr. Stu Bassin:

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[105] *Id.* at 36:15.
[106] *Id.* at 26:49.
[107] *Id.* at 38:00.
[108] *Id.* at 39:59.

> Virtually all of the panel's questions focused upon the statutory construction questions and their implications for the scope of Treasury's authority to promulgate regulations inconsistent with the arms-length comparability standard. The panel appeared to recognize the tension between the arms-length comparability standard and the commensurate with income standard. It questioned, however, the scope of the tension and the range of costs which Treasury could allocate without regard to arms-length comparability analysis.[109]

IX. HOW WILL *PEREZ-GUZMAN* EFFECT THIS CASE

The Court allowed the parties to submit a supplemental brief addressing *Perez-Guzman* and the statute of limitations for a challenge involving the APA. Only Altera submitted a supplemental brief while the government chose not to.[110]

Perez-Guzman is an action brought by an immigrant claiming asylum in the U.S. over fear of torture upon being returned to his native Guatemala.[111] The plaintiff brought an action challenging the validity of an Attorney General Regulation preventing him from applying for asylum in the presence of a removal order.[112] Mr. Perez-Guzman's central claim was refusing his application for asylum was an unreasonable interpretation of the regulations. The Court determined that claim was a substantive claim and thus was not barred by the six-year statute of limitations that begins when the agency rulemaking is complete.[113] However, Mr. Perez-Guzman also argued the agency did not explain its interpretation of the regulation when promulgating the regulation. The court determined this argument was related to procedural error and thus was barred by the six-year statute of limitations for procedural issues which begins when the agency rulemaking is complete, not when it is applied to the petitioner.[114]

Ultimately, *Perez-Guzman* requires a challenge to a procedural violation to the adoption of a regulation by an agency to be done within

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[109] Stu Bassin, *A Second Review of Ninth Circuit Argument in Altera v. Commissioner*, PROCEDURALLY TAXING (Oct. 17, 2017), http://procedurallytaxing.com/a-second-review-of-ninth-circuit-argument-in-altera-v-commissioner.

[110] Altera Corp. v. Comm'r., No. 16-70496, 2018 WL 4924367 (9th Cir. Sept. 28, 2018).

[111] Perez-Guzman v. Lynch, 835 F.3d 1066, 1070 (9th Cir. 2016)

[112] *Id.*

[113] *Id.* at 1077.

[114] *Id.* at 1078.

the six-year statute of limitations; however a challenge to the substance of an agency's decision must be brought within six years of the regulation being applied to the petitioner.[115] The court in *Perez-Guzman* makes clear that even though the government did not raise the statute of limitations defense, it is within their discretion to decide the issue.[116] Altera argues in its supplemental brief that the court should not consider the statute of limitations issue because the government did not raise the defense.[117] *Perez-Guzman* shows that the court is within its discretion in deciding the issue, even though the government did not raise it.

Some, but not all, of Altera's arguments will be barred by the six-year statute of limitations since they are procedural in nature. In *Perez-Guzman*, the petitioner was allowed to bring substantive challenges to a regulation, but the court did not consider the other procedural challenges.[118] Altera's claim that the IRS failed to engage in a notice and comment period and did not consider any comments is clearly a procedural challenge. The court in *Perez-Guzman* cited *Encino Motorcars*, which previously held a challenge that the agency did not give adequate reasons or adequately explain its change in its decisions regarded regulations is a procedural matter.[119] However, Altera's challenge to the IRS interpretation of the regulations seem to be a substantive challenge. Again, Altera's challenge to substantive issues was timely filed and thus will be considered by the court.

U.S.C. § 2401 establishes the statute of limitations for bringing actions against the United States, "every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues."[120] However, this statute only applies when there is no specific statute of limitations period for the case. Since this is a tax case governed by the I.R.C., there is a specific statute of limitations period already applicable. For actions arising out of tax deficiencies, the taxpayer must file a petition "within 90 days . . . after the notice of deficiency authorized in Section 6212 is mailed."[121] As noted by Altera's supplemental brief, Altera timely

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[115] *Id.* at 1077 (citing Wind River Min. Corp. v. United States, 946 F.2d 710, 713–14 (9th Cir. 1991)).
[116] *Id.* at 1077 n.6.
[117] Second Supplemental Brief for the Appellee at *3, Altera Corp. v. Comm'r., 2018 WL 4924367 (9th Cir. Sept. 28, 2018) (Nos. 16-70496, 16-70497), 2018 WL 4929718.
[118] *Perez-Guzman*, 835 F.3d at 1076.
[119] Encino Motorcars, LLC v. Navarro, 136 S.Ct. 2117, 2120 (2016).
[120] 28 U.S.C. § 2401 (2012).
[121] I.R.C. § 6213 (2012).

filed both of its petitions within ninety days of being issued a notice of deficiency.[122] Further, § 2401 only applies to a "civil action" commenced against the United States. This case is a tax case, not a civil action. Since there is an applicable statute of limitations for tax cases in the I.R.C., § 2401 does not apply in this case. This is Altera's best argument against the six-year statute of limitations discussed in *Perez-Guzman.* Altera cites *Wind River Mining Corp. v. United States* in its brief to further the claim that § 2401 only applies to civil cases, which does not include this case.[123] *Wind River* explains that an administrative proceeding is not a civil action, and then applies the statute because the complaint in that case was filed in a federal district court.[124] Altera is an administrative proceeding filed in the Tax Court, not in a federal district court. The § 2401 six-year statute of limitations likely does not apply to Altera for that reason.

X. ALTERA SHOULD WIN THE CASE

Altera should win this case for the following three reasons:

1. There are no comparable transactions involving cost-sharing agreements and stock-based compensation between unrelated parties. There is no way to determine if the parties are dealing at arm's length without a comparable transaction.
2. The IRS interpretation of its regulation would put related parties at a disadvantage compared to unrelated parties, which does not achieve the regulation purpose of achieving tax parity between unrelated and related parties.
3. Finding for the IRS would allow the Treasury and IRS to make arbitrary and capricious decisions on when to use the arm's length standard.

A. *Treasury Has No Evidence of What Unrelated Taxpayers Would Share*

As the Tax Court found, there are no comparable transactions involving cost-sharing agreements between unrelated parties that show unrelated parties would share the cost of stock-based compensation. Furthermore, the commensurate with income standard must be used

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[122] Second Supplemental Brief for the Appellee, *supra* note 117 at *9.
[123] *Id* at *16.
[124] Wind River Min. Corp. v. United States, 946 F.2d 710, 716 (9th Cir. 1991).

consistently with the arm's length standard.[125] The IRS used the commensurate with income standard, but it was not done consistently with the arm's length standard when making the regulation requiring cost sharing agreements to include stock-based compensation. The arm's length standard certainly wasn't meant to be abandoned by the IRS regulation because the preamble of the rule did not mention anything about modifying or abandoning the standard altogether.[126] In fact, the Treasury made clear in the White Paper "that Congress intended no departure from the arm's length standard, and that the Treasury Department would so interpret the new law."[127] Although Commissioner often cites to legislative history in briefs and at oral argument, the legislative history actually shows Congress did not want to depart from the arm's length standard. Congress certainly could not have been thinking of a scenario like this case when adding the commensurate with income standard because transfer pricing and stock-based compensation is a relatively new method of developing a relatively new product, which high profit intangibles.[128] In determining if the parties dealing at arm's length would include stock-based compensation, the IRS did not have any reason for concluding parties would include the compensation.[129] In fact, most commenters during the notice and comment stage found the opposite.[130] The Tax Court concluded that the evidence before the Treasury was contrary to the final rule adopted by the IRS.[131]

The Treasury has no evidence showing that unrelated parties in qualified cost sharing agreements would share stock-based compensation costs, and the commenters to the proposed rule have significant evidence unrelated parties would not share the cost.[132] Rather than the Treasury arguing these determinations, they found the final rule would not conflict with the arm's length standard even if there is no evidence of a transaction between unrelated parties sharing

[125] Altera Corp. v. Comm'r., 145 T.C. 91, 121 (2015).
[126] 26 U.S.C. § 482 (2012).
[127] I.R.S. Notice 88-123, 1988-2 C.B. 458 ("White Paper").
[128] James Bessen, *Accounting for Rising Corporate Profits: Intangibles or Regulatory Rents?*, CATO INSTITUTE (Sept. 21, 2016), https://www.cato.org/publications/research-briefs-economic-policy/accounting-rising-corporate-profits-intangibles.
[129] *Altera,* 145 T.C. 91.
[130] Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,172–73 (Aug. 26, 2003).
[131] *Altera*, 145 T.C. at 131.
[132] Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,172–73.

stock-based compensation costs.[133] However, the final rule does conflict with the arm's length standard because parties operating at arm's length do not share this cost. There was even an example submitted to the Treasury showing an agreement between unrelated parties that does not share the cost.[134] Rather then dispute the evidence, the IRS claimed "[t]he uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA."[135] However, the IRS offers a purely hypothetical situation and has no example of a real transaction that is more similar to a cost sharing agreement than ones the commenters provide.

There is no mention of the intangibles in this regulation having to be "high profit intangibles."[136] There is no other evidence the Treasury relies on because there is none showing an agreement between unrelated parties sharing stock-based compensation. As one commenter explained, unrelated parties would not share stock-based compensation costs because the value of that compensation is speculative and outside the control of both companies.[137] The IRS did not respond to that comment with any relevance, instead dancing around the question claiming the transactions provide for payment on mark ups, which is different than a qualified cost sharing agreement.[138] The IRS also did not give an adequate response to comments claiming stock-based compensation is not actually a cost because no money is being paid to the employees. The IRS fails to see a difference between stock-based compensation and other forms of compensation in the context of cost sharing agreements.[139] The IRS responds by using the legislative history from the 1986 Tax Reform Act, which implemented the commensurate with income standard to "reasonably reflect the actual economic activity undertaken by each."[140] However, that legislative history reflects Congress allocating income, not stock-based compensation. The IRS then claims to implement the Congressional intent in a way that does not satisfy the arm's length

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[133] *Altera*, 145 T.C. at 127.
[134] Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,173.
[135] *Id.*
[136] Treas. Reg. § 1.482-1 (as amended in 2015).
[137] *Id.*
[138] *Id.*
[139] Compensatory Stock Options Under Section 482, 68 Fed. Reg. at 51,172.
[140] *Id.* (citing H.R. Conf. Rep. No. 99-481, at II-638 (1986)).

standard but, against the advice of commenters, the IRS claims it does for no other reason than just because they say so.

> In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees.[141]

As you can read from the above IRS quote, they state the cost sharing agreement must reflect all relevant costs to meet an arm's length standard.[142] Surely, that would be true for most costs that unrelated parties would share in an agreement. However, the IRS does not realize the critical point in this case, and certainly did not have this case in mind in 2003 during the rule making process.[143] Unrelated parties in a cost sharing agreement do not, and would not share stock-based compensation costs. The above quote is the reason the IRS has had to try and push the commensurate with income standard on Altera in order to re-allocate their income, and has tried reconciling that the commensurate with income standard is used when there is no evidence of a comparable transaction. The above quote simply is not true when applied to stock-based compensation. Taking stock-based compensation into account is not consistent with the arm's length standard.

When responding to these comments, the IRS seems to move away from the arm's length standard and start to insert the commensurate with income standard, even though the commensurate with income standard is to be applied consistently with the arm's length standard.[144] As we now can see from the incredibly high amounts of money the departure from the arm's length standard effects, the IRS should have responded more thoroughly and provided actual real examples of arm's length transactions in its response to comments.

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[141] *Id.*

[142] *Id.*

[143] *See Id.*

[144] *Id.* at 51,173 ("Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity.").

B. *Treasury Is Attempting to Abandon a Standard They Made the World Standard*

The commensurate with income standard is not the standard used in treaties or by the rest of the world. The United States has always used the arm's length standard in transfer pricing and was crucial in establishing that standard as the world standard. If the case were decided in favor of the government, it "would be viewed by many as a surprising departure from the arm's length principle, which has been thought of as the bedrock of U.S. transfer pricing standards and which long-standing practice would seem to dictate should be adhered to."[145] The arm's length standard has become the international norm in part because of the Treasury incorporating that standard into treaties with other countries in order to have a consistent standard across the world.[146]

> The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases. This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard.[147]

By abandoning the arm's length standard the Treasury is not just changing the policy for the United States, but making a policy inconsistent with the rest of the world. The amici curiae brief submitted on behalf of the Software and Information Association explains the risk of double taxation that comes with abandoning the

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[145] Peter J. Connors, Barbara S. de Marigny & Michael R. Rodgers, *INSIGHT: A Second Bite at the APA: Altera's Rehearing and the Potential Invalidity of Cost-Sharing Regulations—Part Three*, BNA (Nov. 2, 2018), https://www.bna.com/insight-second-bite-n57982093506.

[146] Altera Corp. v. Comm'r., 145 T.C. 91, 98 (2015).

[147] *Id.*; *see also* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., Jul. 24, 2001; 2006 U.S. Model Income Tax Convention art. 9, Nov. 15, 2006.

arm's length standard and using a standard inconsistent with most other countries.[148] The United States would then be able to allocate costs to another country using a different standard, therefore the other country may not recognize those costs putting the money at risk of double taxation.[149] Treasury should not depart from the international standard that they helped make the norm.

C. *Forcing Related Taxpayers to Share Costs Unrelated Taxpayers Would Not Share Does Not Achieve Parity*

The purpose of Treasury Regulation 1.482 is to "place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."[150] All legislative history and the text of the statute shows the purpose for instituting the arm's length standard is to put all taxpayers in parity with one another.[151] The Supreme Court has also recognized the purpose of I.R.C. § 482 is taxpayer parity in *Commissioner v. First Secretary Bank of Utah*.[152] In that case, the respondents were banks who offered to arrange clients' life insurance policies with a separate life insurance provider.[153] By law, the banks were not allowed to receive commission from the insurance sales, however the Commissioner reallocated income from the insurance company to the banks to account for commission income.[154] The Court held:

> the 'services' rendered by the Banks in making credit insurance available to customers 'would have been compensated had the corporations been dealing with each other at arm's length.' . . . If these Banks had been independent of any such control—as most banks are—no commissions or premiums could have been received lawfully and there would have been no taxable income. As stated in the Treasury Regulations, the 'purpose of section 482 is to place a controlled taxpayer on a tax parity with

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[148] Amici Curiae Brief Supporting Appellee and Affirmance on Behalf of Software and Info. Industry Assoc. et al., Altera Corp. v. Comm'r., 2018 WL 3542989 (Nos. 16-70496, 16-70497), 2016 WL 5369276.
[149] *Id.*
[150] Treas. Reg. § 1.482-1(a) (as amended in 2015).
[151] I.R.C. § 482 (2012); s*ee also* Treas. Reg. 86, art. 45-1(b) (1935).
[152] Comm'r v. First Sec. Bank of Utah, N.A., 405 U.S. 394, 400 (1972).
[153] *Id.* at 394.
[154] *Id.*

> an uncontrolled taxpayer. We think our holding comports with such parity treatment.[155]

Placing additional rules and regulations on controlled taxpayers that do not apply to uncontrolled taxpayers does not achieve the parity purpose of § 482 in the first place. Related taxpayers such as Altera would be punished for using stock-based compensation in cost sharing agreements even though unrelated taxpayers do not use stock-based compensation. As mentioned previously unrelated parties would not use stock-based compensation in cost sharing agreements because of the uncertain nature of the stocks.

The arm's length standard presents a problem in situations where there are no comparable transactions from unrelated parties. However, that should not give the IRS an unchecked license to make any decision they please in those situations without any facts to support their position, as they have done to Altera. In fact, the Commissioner admits he has no evidence showing why sharing the cost of stock-based compensation achieves tax parity or is consistent with the arm's length standard.[156] As Altera states in its brief,

> "the Final Rule construes section 482 to require controlled taxpayers to share stock-based compensation in every case without any showing that unrelated parties would ever do so. That absolute rule—entirely untethered and contrary to empirical evidence—is inconsistent with the purpose of the statute to impose tax parity between controlled and uncontrolled taxpayers."[157]

The IRS is unable to show any transactions with unrelated parties sharing stock-based compensation, therefore forcing related parties to share stock-based compensation costs is not achieving taxpayer parity. The reason there are no comparable transactions in this case is because unrelated parties would never share stock-based compensation costs, so why should related parties be forced to share those costs. Allowing the Treasury to pick and choose when to use the arm's length standard and when to make up its own rules for what the Treasury believes unrelated parties would do is obviously very dangerous and gives far too much power to the Treasury, especially when they ignore

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[155] *Id.* at 406–07.
[156] Brief for the Appellee, *supra* note 40 at *15.
[157] *Id.* at *71.

legitimate comments to the proposed rulemaking, as they have done here.[158]

D. *Treasury Did Not Engage in Reasoned Decision Making*

As the Tax Court found, the Treasury's rule should not be given *Chevron* or *State Farm* deference because this was not reasoned decisionmaking.[159] The APA states the "reviewing court shall . . . hold unlawful and set aside agency actions, findings, and conclusions found to be arbitrary, capricious . . . ."[160] If the agency engages in reasoned decisionmaking, its actions and findings are not arbitrary and capricious.[161] As we know from *State Farm,* for an agency to engage in reasoned decisionmaking, the agency must show a "rational connection between the facts found and the choice made."[162] The agency must also show awareness that it is changing positions if the agency action departs from an old position or adopts and follows a new position.[163] Both the IRS and Altera agree that the final rule made by the Treasury has the purpose of placing related and unrelated taxpayers in parity with one another. This is done by using the arm's length standard for agreement involving related taxpayers.[164] The question for determining whether the final rule is valid is, did the agency use reasoned decisionmaking?

The Tax Court found that the Treasury did not engage in reasoned decisionmaking because it did not connect the position to facts found.[165] The Tax Court relied heavily on the preamble of the rule, in which the Treasury stated beliefs that unrelated parties entering into cost sharing agreements to develop intangibles would include stock-based compensation if it was a significant element of the costs.[166] Not all cost sharing agreements are for intangibles, and further not all cost

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[158] Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,173 (Aug. 26, 2003).
[159] Altera Corp. v. Comm'r., 145 T.C. 91, 121 (2015).
[160] 5 U.S.C. § 706(2)(a) (2012).
[161] *Altera*, 145 T.C. at 113.
[162] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).
[163] FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).
[164] Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,172 (Aug. 26, 2003) ("Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard.").
[165] *Altera*, 145 T.C. at 126.
[166] *Id.*

sharing agreements have stock-based compensation as a significant cots, yet the Treasury does not respond to that argument and makes a final rule that covers all cost sharing agreements.[167] Another factor showing Treasury's failure to use reasoned decisionmaking comes from the fact that they have no evidence showing any support for their belief that unrelated parties would share this cost. Many commenters in the notice and comment stage explained exactly why unrelated parties would never share that cost, but Treasury ignored those comments because there was no answer for them.

Commissioner has responded to the Tax Court's allegations by relying on *Michigan v. EPA* which has a different definition for reasoned decisionmaking. Rather than looking at facts and evidence to make the final rule rational, that case only requires the process by which the agency makes its decision to be rational and logical.[168] However, the commissioner's brief fails to include the rest of the paragraph after "result must be logical and rational" in *Michigan v. EPA.*[169] The opinion in *Michigan v. EPA* goes on to say "[i]t follows that agency action is lawful only if it rests 'on a consideration of the relevant factors,'" which comes from *State Farm.*[170] The agency in that case, which was the EPA, actually lost because they did not consider all relevant factors.[171]

The Commissioner repeatedly justifies I.R.C. § 482 by using the legislative history to show that Congress wanted a commensurate with income standard that is consistent with an arm's length standard.[172] As previously noted, that is impossible in this case under § 482 because an arm's length standard would not make controlled taxpayers share stock-based compensation costs because uncontrolled parties would never do that. The Commissioner's brief attempts to respond to this argument by claiming "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."[173] This argument is flawed because there is no way of knowing what an uncontrolled taxpayer would do in a hypothetical situation that would never occur. In fact, the hypothetical situation is flawed because

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[167] *Id.*
[168] Michigan v. EPA, 135 S.Ct. 2699, 2706 (2015).
[169] Brief for the Appellant, *supra* note 42 at *43.
[170] *Michigan*, 135 S.Ct. at 2706.
[171] *Id.* at 2711.
[172] Brief for the Appellant, *supra* note 42 at *61–*62.
[173] *Id.* (citing Compensatory Stock Options Under Section 482, 68 Fed. Reg. 51,171, 51,172 (Aug. 26, 2003)).

uncontrolled taxpayers have good reason never to share stock-based compensation. The Commissioner and Treasury are simply choosing a hypothetical that would never happen to align with their desired rule in order to claim this is reasoned decision making. Doesn't this sound arbitrary and capricious since it is without any evidence? In fact the only evidence is presented by commenters explaining why unrelated parties would not share these costs.

XI. CONCLUSION

What this case comes down to is tax evasion versus tax avoidance. The Commissioner would claim leaving stock-based compensation out of the cost sharing agreement cost pool, as Altera and many other companies have done, is tax evasion, and thus, Altera needs to pay its true tax liability. Altera would claim it is simply engaging in a legally strategic tax avoidance strategy to reduce its tax liability.[174] The case will have major implications on the way Treasury follows the APA, their response to comments during the notice and comment stage of administrative rulemaking, and how tech companies determine their tax liability.

Should the IRS win the case, the arm's length standard may no longer be the international standard for transfer pricing. Another consequence would be a large increase in power allowing the IRS to reallocate costs and income in transfer pricing based on their idea of what is commensurate with income, which will most likely be a way to increase companies' tax liability. Should the Ninth Circuit reverse and find for Altera, the IRS will continue to miss out on billions of tax dollars they believe should be paid. Regardless of the outcome, the losing side is likely to attempt to bring the case to the Supreme Court, and with such huge implications, SCOTUS should hear the case.

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[174] *Tax Avoidance Is Legal; Tax Evasion Is Criminal*, WOLTERS KLUWER, https://www.bizfilings.com/toolkit/research-topics/managing-your-taxes/federal-taxes/tax-avoidance-is-legal-tax-evasion-is-criminal (last visited Apr. 18, 2019).